Financial Performance Representations Workshop

IBA/IFA26
JOINT CONFERENCE

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Today's Agenda

- "Financial Performance Representations," "Earnings Claims" and other information for the common question asked by prospective franchisees:

  "How much will I make?"

- Overview of legal framework for franchising and FPRs in USA, Brazil, and Switzerland
- Practical considerations: Whether, how and when to make an FPR and factors when expanding into new countries

Franchise Legal Framework – United States

- Franchises are a regulated business by both the federal government and many states
- There is a federal rule that requires affirmative pre-sale disclosure of certain items and sets rules for compliance with those disclosures (the “FTC Rule”)
- States may also regulate franchising, including to require additional disclosures, registration, and regulate certain aspects of the franchise relationship
  - Franchise Registration: 14 states require pre-sale registration or exemption
  - Registration process involves state review of FDD and particular focus on any FPRs
- Compliance with the federal disclosure (which must be updated each year within 120 days after the end of the franchisor’s fiscal year) and the relevant state requirements must be abided by before any attempt to sell or take money occurs
- Franchise rules restrict sales of franchises to the information largely contained within these disclosure documents – ensures ‘full and fair’ information
- States also have anti-fraud laws

Franchise Legal Framework – United States: Rules Governing FPRs

- No requirement to disclose financial performance information to prospective franchisees
- At least 60% of franchisors put financial information in FDD, and this percentage is increasing
- **<u>Whatever is disclosed in Item 19 is the ONLY financial performance information you can disclose to a prospective franchisee*</u>**
    - *Certain exceptions and exclusions apply

US Law: What is an FPR?

"Financial Performance Representation" is defined by FTC Rule as:

- Any representation, including any oral, written or visual representation
- To a prospective franchisee
- That states, expressly or by implication a specific level or range of actual or potential sales, income, gross profits or net profits
- Includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables

- Other terms used include FPR, earnings claim (from earlier US franchise rules), and Item 19 (refers to the relevant portion of the FDD)

US Law: What is NOT an FPR?

- Statements by existing franchisees to prospective franchisees
- Actual operating results for a specific outlet in connection with sale of that outlet given only to potential purchasers
- Information to lender directly in connection with arranging of financing
- Statements made to existing franchisees
- Cost or expense data that is not stated as a percentage of sales, etc.
- Blank proforma (caution)

*Certain limits and cautions apply to the exceptions

US Law: Requirements to Make an FPR

- You must have a “reasonable basis” at the time FPR is made
- You must have written substantiation and make it available to prospective franchisees who ask
- You must include the FPR in Item 19 of your FDD
  - State basis and assumption
  - May include subsets
- FPRs may be either
  - Historical financial data based on performance of franchised or company-owned outlets
  - Projections of potential future performance

Franchise Legal Framework – Brazil

- Brazil franchising market – 4,000 franchisors, 200,000 franchisees,163 brands in 100 countries
- Franchising Law
  - COF – 10 days prior to contract
- Consequences of FPR in the COF
- Valid FPR –
  - Clear estimates or actual examples
  - Verifiable data
- No guarantee
- Disclaimers

Franchise Legal Framework – Brazil

- General practices by franchisors
- Invalid FPR – Implied profitability, misleading information or omission of essential information
- ABF – Ethics Committee – Code of Conduct
- Advertising – False or misleading
- CONAR
- Procon and courts

Franchise Legal Framework – Switzerland

- Art. 1 CO: A contract is valid when the parties have mutually and in a consistent manner expressed their intent
  - This expression may be explicit or implicit
- Art 18 CO: In order to assess the form and terms of a contract, one must determine the actual and common intention of the parties, without taking into consideration any inaccurate expressions or terms they may have used, whether by mistake or to conceal the true nature of the agreement

Franchise Legal Framework – Switzerland

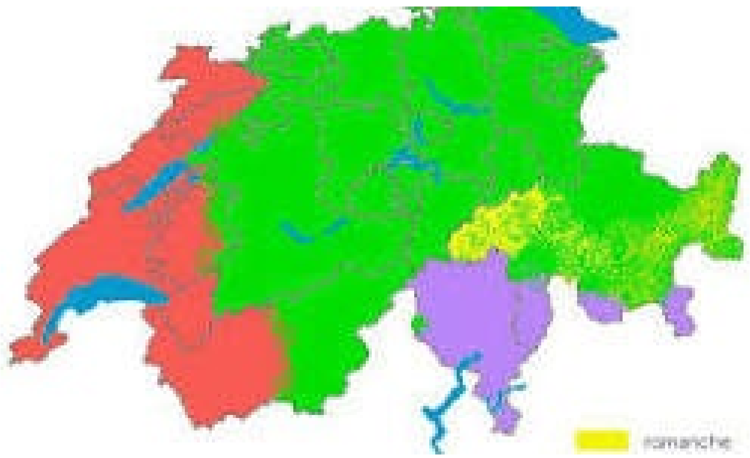
- Named contract (*numerus clausus*) vs. unnamed contract
- No specific legal regime for franchise agreement
- In principle, unnamed contract including elements of sales, licensing, service
- Determination of the actual and common intention of the parties (by all means)

Franchise Legal Framework – Switzerland

- No express legal obligation to disclose (including FPRs)
- Two major principles:
    - Obligation to act in **good faith**; and
    - The concept of **culpa in contrahendo**
- Negotiation phase: Tensions between the parties
- What has been disclosed and what could have been disclosed

Franchise Legal Framework – Switzerland

- Some peculiarities of the Swiss market and their impact on FPRs



Franchise Legal Framework – Switzerland

- Some peculiarities of the Swiss market and their impact on FPRs
  - Small territory
  - Three main languages – Equivalent to surrounding countries' languages
  - Purchasing power and the standard of living are higher in Switzerland than in surrounding countries
  - Existing data vs. prospective data
  - In (competition) law: The relative market power concept

Types and Examples of FPRs

- Statements of gross sales, gross margins, gross profit or net income – *Almost anything that relates to $ operating results*
- Average unit revenues or income
- Return on investment (ROI)
- Annual break even
- Media claims – Articles provided to prospective franchisees

Examples of FPRs

- I looked at the financial projections you prepared. They look fine.
- Franchise Times reported that our average units do more than $15,000 per week in sales.
- You will break even in 15 months.
- You will see a 100% return on investment within the first year of operation.
- You will earn enough money to buy a new Porsche.
- Most all our franchisees are clearing $1,000 a week. I don't know anyone who is making less than that.
- We can make you a millionaire.
- You can expect annual sales of $550,000 and a profit margin of 33%.

Practical Considerations for FPRs and International Expansion

- What is sufficient to be a “reasonable basis”?
- Evaluating available data and suitability for the new market
  - Distinguishing characteristics
  - Comparability of results
- What market factors are different?
  - How can those factors be addressed in the FPR?
  - Will the new jurisdiction allow FPRs based on operations in another country?
  - What types of explanations or adjustments will be allowed to account for market differences?

Practical Considerations

- Historical vs. projection
- Determining most relevant data and metrics
- Impact of adjustments for market conditions
- Reliability of data – Cross jurisdiction concerns
- Proformas and worksheets

Putting it into Practice:

Examples

- Restaurant chain with significant number of company-owned units in multiple EU countries
- US franchised system focused on home services
- South American-based system focused on personal care services
- Asia Pacific-based businesses selling proprietary products

Questions

- What factors do you evaluate?
- What descriptions and explanations do you provide?
- What is the potential impact of any regulatory review and approval required?
- Are there alternatives?

Practical Considerations and Suggestions

- Training for anyone who will talk with a prospective franchisee
  - Explain the rules for each country, which may differ significantly
  - Adopt a company policy that any claims or representations related to earnings, sales or profits be in writing
  - Have a compliance policy that details the penalties for violations
- Maintain records of who receives disclosures
- Marketing: Be careful to review all
  - Data in marketing materials must match the disclosure documents
  - Includes email campaigns, and other digital activities (in US, additional limits and conditions apply under some state franchise laws)

Practical Considerations – Substantiation, Updates & Monitoring

Substantiation

- Document material assumptions
- Maintain summary spreadsheet and back-up records of all "adjustments" made to the actual raw data, and keep as "substantiating documentation" in files to produce upon request
- Know why you excluded any outlet which otherwise meets selection criteria

Updates and Monitoring

  - Be aware of regular updates in new market
  - Monitor for changes and whether units in new market perform as expected or in comparison to the FPR

Wrap-Up

Questions? Comments?